

DEFENSE SPENDING AND THE ECONOMY

Rudolph G. Penner
Director
Congressional Budget Office

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Mr. Chairman, I appreciate the opportunity to testify today on the effects of defense spending on the economy.

The United States is in the midst of a program of strengthening its military capabilities. The Congress has approved \$264 billion in budget authority for the national defense function in fiscal year 1984. After adjustment for inflation, that represents an increase of about 40 percent over the 1980 level. The Administration has proposed further increases that, if enacted, would raise budget authority for national defense to \$456 billion in fiscal year 1989. That would amount to additional real increases of 38 percent under the Administration's economic assumptions and 28 percent under CBO's assumptions, which anticipate higher future inflation. Again depending on economic assumptions, outlays under the Administration plan would comprise between 7½ and 8 percent of gross national product in 1989, up from about 5½ percent in 1980.

This higher defense spending uses an increasing share of the economy's resources, thereby reducing private consumption, investment, and other public spending below otherwise attainable levels. The Congress must make the difficult, but key political judgment: whether the added defense spending contributes enough to national security to justify this cost.

A secondary issue, but always of interest, is the effects of defense spending on the economy. The economy currently is improving. Despite high interest rates and the great uncertainty caused by large federal

deficits, CBO expects that the economy will continue improving through 1985, with falling unemployment rates and no significant increase in inflation. Some fear that the large deficits may abort economic expansion before the end of 1985. While we acknowledge this risk, it is our best judgment that economic expansion will continue over the next two years. The major harm done by the deficits is to our longer-run prospects for economic growth and higher future standards of living.

As we see the next few years, it does not appear that rising defense spending will impair price stability, employment, or any other broad measure of economic performance. Growing defense spending does, however, heighten some risks specific to the defense sector, principally those of higher weapons costs.

ECONOMIC OUTLOOK

Short-Run Outlook Is Favorable

CBO's short-run economic forecast foresees continuing growth with declining unemployment and only moderate inflation in 1984 and 1985. This forecast assumes:

- o Federal spending policies are those now in place, including real annual increases of roughly 5 percent in defense budget authority;
- o Federal tax policies remain unchanged;

- o Growth in the M1 money aggregate is 6.0 percent in calendar 1984, at the middle of the Federal Reserve's range, and 5.5 percent during 1985;
- o No price shocks or international credit crises occur.

With these assumptions, we project that real gross national product (GNP) will rise 4.7 percent over the four quarters of 1984 and 3.7 percent during 1985 (see Table 1). Averaged over the two years, the projections are slightly above the average for the second and third years of previous post-World-War-II upturns. The forecast projects that the civilian unemployment rate will decline from 8.5 percent in the last quarter of 1983 to 7.6 percent by the end of 1984 and to 7.1 by late 1985.

TABLE 1. THE CBO FORECAST FOR 1984 AND 1985

Economic Variable	Actual		Forecast	
	1982	1983	1984	1985
Fourth Quarter to Fourth Quarter (percent change)				
Nominal GNP	2.6	10.5	10.3	9.0
Real GNP	-1.7	6.1	4.7	3.7
GNP Implicit Price Deflator	4.4	4.1	5.3	5.1
Consumer Price Index for Urban Consumers	4.5	3.3	5.1	4.9
Calendar Year Average (percent)				
Civilian Unemployment Rate	9.7	9.6	7.8	7.3
Three-Month Treasury Bill Rate	10.6	8.6	8.9	8.6

We expect that inflation, as measured by the GNP deflator, will increase slightly from 4.1 percent in 1983 to 5.3 percent over the four quarters of 1984 and to 5.1 percent in 1985. This increase in inflation reflects temporary factors—for example, the decline in oil prices last year that is not expected to be repeated this year, and a temporary acceleration in food prices in 1984. In addition, the relatively rapid reduction of slack in the economy probably will keep inflation from falling rapidly. Nevertheless, the CBO forecast is broadly consistent with the hypothesis that inflation is on a long-term downward trend.

The three-month Treasury bill rate is projected to average 8.9 percent this calendar year and slightly lower next year. Interest rates remain very high in real terms—that is, after adjustment for inflation—because of the exceptionally large amount of Treasury borrowing combined with strengthened private credit demands. This forecast projects that the unified federal deficit will be about \$189 billion in fiscal 1984, rising to \$197 billion in 1985.

Inflation Risks in the Outyears

Although we do not project much higher inflation or renewed recession through 1985, risks abound especially in the years beyond 1985. Indeed, beyond 1985 CBO does not make a forecast; instead we make projections based on noncyclical historical trends that may not be consistent with a

continuation of current fiscal policy. (Specifically, we assume that the real growth rate from the recession trough in the fourth quarter of 1982 to the end of 1989 will equal the average of growth rates experienced during other similar postwar periods.) We believe that slowly declining inflation is consistent with these trends. But the relationship between inflation, real growth, and unemployment is highly unstable and, therefore, we cannot dismiss the possibility that inflation may rise rather than decline.

One indication of this risk comes from projections of capacity use in manufacturing. These projections show use of manufacturing capacity in 1986 reaching 87 percent, around levels attained in 1968-1969, 1973-1974, and 1978-1979 (see Table 2). Inflation rose in each of those earlier periods.

Rising inflation may still be avoided, with proper policies and better luck than in the past. In each of the earlier periods just mentioned, accelerating money growth predisposed the economy to inflation. Oil price shocks added to inflation in two of those periods. We do not anticipate that either of these unfortunate factors will play a part during the next few years. Moreover, there is always a chance that growth will fall short of our projected path, resulting in less upward pressure on prices.

Free trade could also prove valuable in countering inflation in the United States. Most forecasters foresee sluggish growth and surplus capacity abroad during the next couple of years (see Table 3). Particularly with respect to volatile prices of commodities such as metals, the absence of trade barriers could be the key to stopping inflation in the United States.

TABLE 2. CAPACITY USE IN MAJOR MANUFACTURING INDUSTRIES: PAST AND PROJECTED (In percent)

	Average 1948-1980	Annual Peak Rates			Actual			Projected a/		
		1968-1969	1973-1974	1978-1979	1980	1982	1983	1984	1985	1986
Total Manufacturing	83	87	88	86	80	71	75	82	85	87
Defense Intensive b/										
Aerospace, etc.	73	89	76	91	89	71	69	74	82	88
Instruments	82	85	88	90	86	77	75	80	82	89
Electrical equip.	83	84	87	89	84	77	81	88	90	92
Fabricated metals	79	86	85	88	79	66	68	76	81	83
Nonferrous metals	85	89	96	92	81	56	74	82	92	99
Iron and steel	84	91	97	89	73	51	62	79	87	91
Petroleum refining	91	96	97	91	79	74	75	79	81	81
Others										
Motor vehicles	82	92	95	89	59	57	72	88	89	88
Nonelectric machinery	81	86	87	82	78	66	65	75	79	82
Clay, glass, stone	82	79	87	84	73	65	71	79	82	84
Food	83	84	85	86	85	77	77	79	81	82
Textiles	88	92	94	87	83	76	86	93	94	93
Paper	90	94	95	91	88	86	92	98	97	96
Chemicals	81	82	85	83	77	65	69	76	78	81
Rubber/plastics	88	99	94	89	80	76	86	97	99	99

SOURCES: Board of Governors of the Federal Reserve System and CBO projections.

a. Based on CBO's baseline economic projections presented in The Economic Outlook (February 1984).

b. Industries with a higher-than-average share of production stimulated by defense.

TABLE 3. OUTLOOK FOR REAL GNP GROWTH--WORLDWIDE AND
IN THE UNITED STATES (Percent change)

	1981	1982	1983	1984	1985
World <u>a/</u>	1.7	-0.2	2.0	3.8	3.0
United States <u>a/</u>	2.6	-1.9	3.4	5.3	3.3
United States <u>b/</u>	2.6	-1.9	3.3	5.4	4.1

SOURCES: DRI Review (January 1984) and CBO projections.

a. From Data Resources, Inc.

b. From CBO.

High Deficits Pose the Major Economic Risk

While a tightening of capacity hints at the possibility of higher inflation, federal deficits of the size that we now foresee pose an unmistakable threat to economic growth. Under current tax and spending policies, including 5 percent annual real growth in defense budget authority, federal deficits would grow from about \$189 billion in 1984 (5.3 percent of GNP) to \$308 billion in 1989 (5.7 percent of GNP). 1/

1. The 1989 estimate is lower by \$18 billion than the estimate published in CBO's Baseline Budget Projections for Fiscal Years 1985-1989. A part of the reduction stems from changes in the mix of defense spending between investment and operating accounts and other technical information which was not available when previous projections were made. Most of the change, however, reflects a reduction in the estimated rate of inflation in the defense sector of the economy.

Federal deficits of these magnitudes would probably retard the accumulation of capital and hence slow economic growth and reduce future standards of living. This gradual erosion of our future prospects is probably the most likely result of such huge deficits, rather than some dramatic near-term reversal in economic performance.

High federal deficits retard the accumulation of private capital by reducing savings available for investment. In fiscal year 1983, the federal deficit was about 107 percent of domestic net private savings. If historical savings rates persist--as our forecast indicates--federal deficits would average about 79 percent of net private savings in fiscal years 1984-1985. When the government borrows so much, most economists agree that interest rates are bid up and capital accumulation is held down.

Large capital inflows from abroad have so far limited the rise in interest rates and the effects on domestic capital accumulation. But these capital inflows are not a costless remedy for deficits. The commitments to pay interest and dividends to foreigners become a liability against future U.S. standards of living.

Huge deficits also lead to soaring interest costs that restrict future budgetary choices. The U.S. government is accumulating debt faster than GNP is growing, and this cannot continue indefinitely without eroding confidence in the creditworthiness of both the U.S. government and other U.S. borrowers. The greatest threat is a crisis of confidence that would

reduce willingness to lend to U.S. borrowers, triggering sharply higher interest rates. If that occurred, interest costs on the debt, which under our baseline assumptions are already climbing from 2.8 percent of GNP in fiscal year 1983 to 4 percent in 1989, could grow to even higher levels. For a given level of taxes, this could severely restrict future budgetary choices.

DEFENSE NEED NOT HARM THE ECONOMY

By contributing to the deficit, rising defense spending adds to the risks that I have just discussed. But if other actions are taken to reduce deficits substantially, we see no reason why the military buildup would harm overall economic performance.

Defense Buildup Need Not Worsen Inflation

The role of defense spending in spurring inflation often is exaggerated. For one thing, further growth of the defense budget will add only marginally to any tightening of labor markets and manufacturing capacity. For example, if real growth in defense budget authority were cut to zero in 1985 and 1986, employment would decrease only a small fraction of a percent. Capacity use in manufacturing in 1986 would decline only about one percentage point to 86 percent, still equalling the peak annual rate achieved in 1978-1979.

Defense spending makes a big difference in some sectors, but these account for too little of GNP to affect inflation greatly. Last February, for example, we noted possible spot shortages in several specific industries that do much defense work. These industries included many of the firms making aerospace products, specialty metals, electronics equipment and parts, instruments, and metal fabrications such as forgings. We projected that production in 36 of 100 defense industries (in the four-digit Standard Industrial Classification) would have to be "unusually high" to meet demand in 1986. (Unusually high means more than one standard deviation above the industry's production trend over the past 10-15 years.) These 36 industries, however, accounted for only 3.6 percent of GNP in 1981 and so shortages in them should pose little risk of rekindling inflation in the economy as a whole. We are currently updating this analysis on the basis of current forecasts and budgets, but we do not anticipate major changes in the results.

Defense Buildup Unlikely to Slow Employment Gains

Some critics of higher defense spending warn that it will depress employment below levels that would exist if nondefense spending were raised by an equal amount. But this argument finds little support in economic research. In the long run, employment seems to be determined largely by the size of the labor force, which has little to do with the mix of defense and nondefense spending.

Even in the short run, increases in overall defense or nondefense spending on goods and services probably have about the same effect on total employment. While large econometric models vary widely in many of their predictions, they generally agree that the short-run stimulus to employment provided by higher defense or nondefense purchases is about the same. These models also usually predict somewhat smaller short-run gains from cutting taxes or increasing federal transfer payments.

Not all economists agree with the short-run predictions of these econometric models. Some economists contend that changes in the rate of growth of the money supply are more important to economic activity than these models suggest. Some even propose that only unanticipated increases in money can cause output to rise above the path it would obtain without policy changes. But regardless of the validity of these views, we would not expect to observe large differences in employment stimulated by added defense or nondefense purchases. All of the theories predict about equal effects for these different forms of spending.

More generally, it should be noted that many forms of defense spending have very similar counterparts in the nondefense budget. It would be surprising if the construction of aircraft runways had macroeconomic effects very different from the construction of highways; or if an increase in military retired pay had effects very different from an increase in Social Security; or if increased Pentagon hiring had effects different from increased employment in nondefense departments of the government.

PROGRESS HAS BEEN MADE ON WEAPONS COST GROWTH

BUT RISKS CONTINUE

While higher defense spending need not harm employment or inflation, it could rekindle weapons cost growth. Recent evidence suggests progress in the difficult effort to stem the growth in unit costs of weapons systems. The Department of Defense periodically reports on costs of major weapons systems in the Selected Acquisition Report (SAR). CBO analyzed the December 1982 SAR, which was received in March 1983 and was consistent with last year's budget. We found that, by a number of measures, growth in the cost of a unit of equipment had fallen substantially below the very high levels of the early 1980s. The Congress has not yet received the SAR consistent with the latest budget. But preliminary results are encouraging. Using data in the President's budget, we have been able to analyze costs for 74 systems. Unit costs for 1985 in this budget are lower than anticipated a year ago for 43 systems and higher for only 31 systems. On balance, these changes reduced 1985 budget authority by \$2.4 billion below levels that otherwise would have been needed.

Despite these encouraging results, there are risks of continued cost growth. In the SAR received last March, 19 of the 62 systems were behind their planned delivery schedules. Fourteen others reported delays in completing key program milestones. This suggests there may be problems that could lead to future cost growth.

Potential bottlenecks in defense-specific industries, which I noted above, also pose a risk of future weapons cost growth. The 36 defense-specific industries that CBO identified last year as having potential bottlenecks accounted for 40 percent of defense purchases from private industry in 1981. Such bottlenecks might raise weapons costs.

Underestimates of inflation pose another risk. Over the next five years, the Administration projects less inflation in weapons systems costs than CBO does. Long-run inflation estimates are inevitably highly uncertain. But they are important in estimating weapons costs since most weapons will be produced and paid for over several years. Thus, if CBO's assumptions are correct, the Administration's underestimates could cause underfunding now, leading to weapons cost growth in the future.

Part of the difference in these estimates stems from differences in assumptions about inflation in the economy as a whole. In addition, CBO assumes that inflation in defense purchases (excluding fuel) will exceed inflation in the GNP deflator by about 1.6 percentage points a year, as it has in the last five years. The Administration also assumes higher inflation in some defense purchases, but to a lesser degree. When combined, these differences mean that, over the next five years, the Administration's estimates of inflation for defense purchases average almost two percentage points lower than that assumed by CBO.

CBO's economic assumptions, if they are correct, would require that \$5 billion be added to defense budget authority in 1985 to fund the Administration's program fully for inflation. Over the next five years, a total of \$94 billion in budget authority would have to be added, an increase of about 5 percent above the Administration's proposed funding. Alternatively, if the Congress approves no more than the Administration's dollar request, and prices turn out to be as CBO forecasts, defense purchases or personnel would have to be cut.

DEFENSE MUST BE PAID FOR

The key macroeconomic risk from rising defense spending occurs when it is financed by borrowing and, along with other tax and spending policies, is allowed to add to growing federal deficits. As I mentioned earlier, the CBO baseline--which assumes 5 percent real growth in defense budget authority--leads to a \$308 billion deficit in fiscal year 1989. This deficit would equal 5.7 percent of GNP, far above even the peak ratios in the 1970s or earlier.

Defense spending, of course, is only a part of an overall policy that leads to high deficits. Even if there were no real growth in defense budget authority in 1985 and beyond, and other tax and spending policies remained unchanged, the deficit in 1989 would still equal about \$230 billion. This would be substantially smaller than \$308 billion and, as a fraction of GNP,

would represent a decline from the 1984 level of 5.3 percent to 4.3 percent. But even with no real growth in defense, deficits would be very large.

SUMMARY

In sum, Mr. Chairman, it is clear that defense spending imposes a major cost on the economy since it absorbs resources that could be put to other uses. Obviously we would be better off as a nation if we lived in a more peaceful world and could get along with a much lower defense effort.

Given the world as it exists, deciding exactly how much of our GNP need be devoted to defense is not easy. In making this hard choice, our analysis suggests that the Congress should be guided by what it considers necessary for the safety of our nation. Defense spending in itself poses no more threat of inflation, unemployment, or long-run injury to the economy than any other type of federal purchase.

The key issue for the economy is how the defense buildup is financed. To the extent that it is financed by borrowing, the cost falls heavily on private capital formation, and tends to be at the expense of future economic growth and living standards. To the extent that the buildup is financed by cutting nondefense spending or raising taxes, it may be paid for out of current consumption, thus leaving our potential for future growth less impaired.